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Market Facts

Single Commodity Impact On Financial Markets After May 2006

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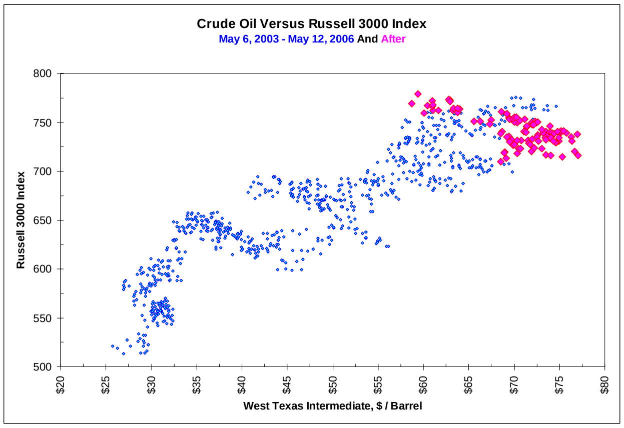
Very few dates are identifiable as global reversal points for multiple markets, but May 12, 2006 is an exception, one we identified early in a Commentary dated May 18th. The abrupt withdrawal by the Bank of Japan of excess liquidity led to downturns in emerging market equities, expected inflation as measured by the ten-year TIPS breakeven rate of inflation and numerous individual commodities.

In keeping with our long-held and demonstrable conclusion discussed in an April 2005 Market Facts there is no such thing as "commodities," just a collection of tangible assets underlying exchange-traded futures and consigned to common trading forces by index funds, let's examine a subset of a very large data analysis regarding the relationship between various commodities and financial markets over two periods, May 6, 2003 – May 12, 2006 and May 12, 2006 – October 4, 2006. May 6, 2003 was when the FOMC declared war on deflation. **The first period will be displayed with blue markers and the second with magenta markers in all subsequent charts.**

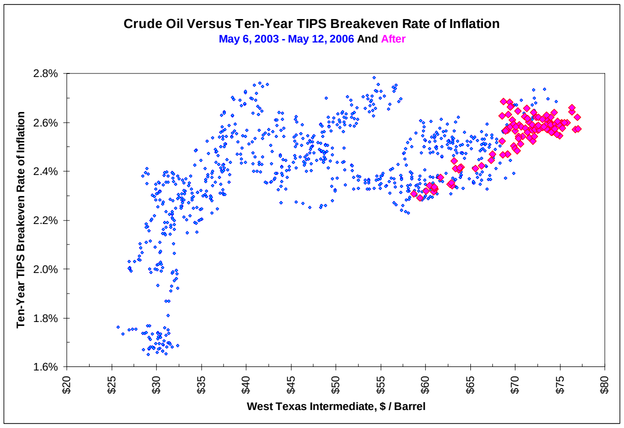
The financial markets examined included the MSCI Emerging Markets Free index, the MSCI Europe, Australasia and Far East (EAFE) index, the Russell 3000 index, the Nikkei 225 index, U.S. ten-year and two-year note yields, the forward rate ratio between two- and ten-years, the ten-year TIPS breakeven rate of inflation, the carry, addressed in a May Commentary, between three-month Japanese yen and U.S. ten-year notes, the dollar index and the option-adjusted spreads for both investment-grade and high-yield American corporate bonds. A large set of commodities were examined, but the discussion below will be constrained to crude oil, copper and gold.

Crude Oil Highlights

Much of the recent advance in U.S. equities was attributed to the decline in crude oil. None of the 2003-2006 advance in U.S. equities was attributed to the increase in crude oil. We first identified this benign impact of rising crude oil prices in a February 2005 Commentary, and its veracity remains: the two periods appear virtually identical.

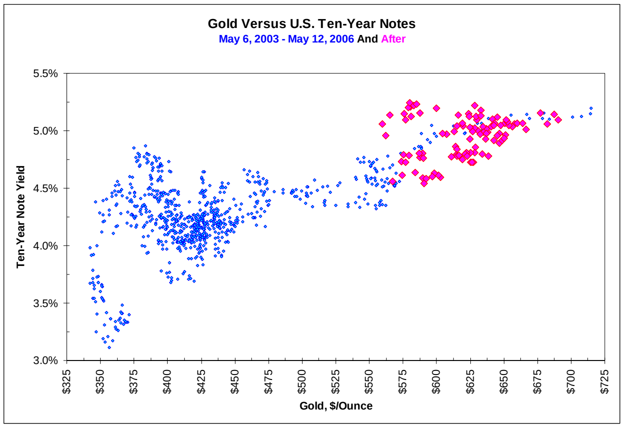


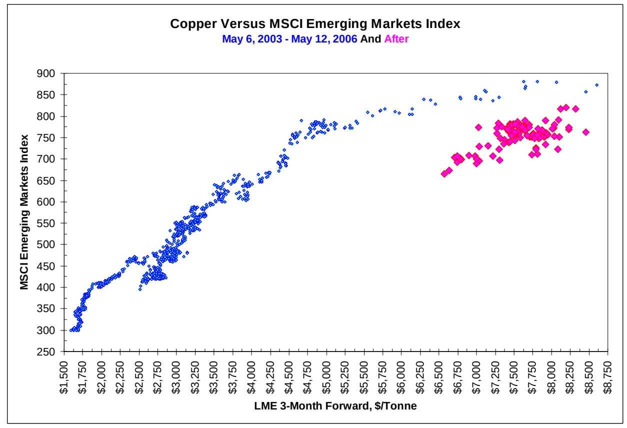
The break in crude oil prices did coincide with a decline in inflation expectations, a topic addressed in our most recent Commentary, however. Left unanswered is why the relationship between TIPS breakevens and crude oil had been so asymmetric previously; please note how the increase between $40 and $65 per barrel coincided with a ***decline*** in TIPS breakevens.



Gold Highlights

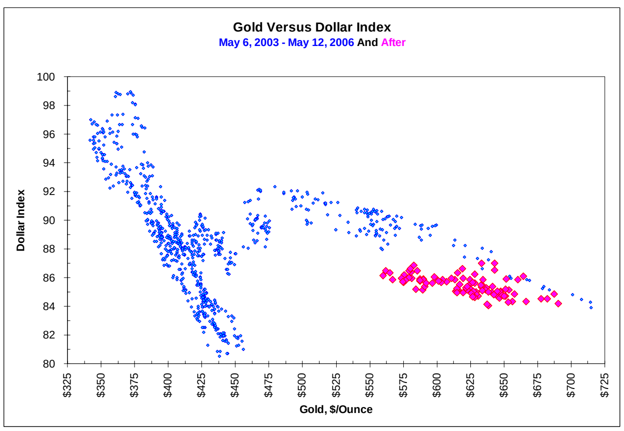
Market veterans recall the instant and indelible association between rising gold prices and rising interest rates. This relationship has remained stable after a fashion; we still see (following page) a positive correlation between gold prices and ten-year note yields.

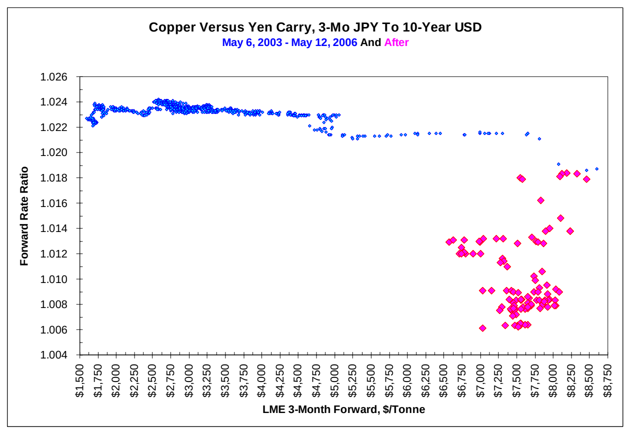




The most dangerous words for analysts are supposed to be, "It's different this time." The opposite is not true, however. While rising gold prices and a weaker U.S. dollar once went together – please see the period between $350 and $450 per ounce on the next page – the relationship weakened significantly after that.

If strong global growth was financed by borrowing yen cheaply, we should see the flattening of the forward rate ratio between three-month yen and ten-year dollars affect copper negatively. While the data sample is still too small to draw any meaningful conclusions, such a pattern does seem to be developing.





Copper Highlights

The surge in copper, addressed in a May Commentary, was matched by the rise in emerging market equities between 2003 and 2006. After both markets broke in May 2006, the correlation remained near-constant but at a lower level. The same global growth story propels both markets.

Conclusion

All previous examinations of the relationships between commodities and financial markets concluded the impact of higher single commodity prices on financial variables was either negligible or benign. In no cases have the effects of single commodity prices on financial markets justified the level of attention devoted thereto.

Today information and services dwarf tangible process inputs in importance. The largest physical commodity markets are small compared to financial markets. Few relationships in the larger study were clear and direct.

The "hot" phase of what may still be an intact long-term bull market in most commodities is over. It damaged far less in both the macro-economy and in financial markets than we might have feared. If symmetry holds, the downturn will not be a cause for larger celebration.

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